ANSON CO.

IBLA 96-311 Decided August 21, 1998

Appeal from a joint Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, and the Deputy Commissioner of the Bureau of Indian Affairs affirming an order of the Dallas Compliance Division to recalculate royalties. MMS 94-0635-IND.

Affirmed.

1. Indians: Mineral Resources: Oil and Gas: Royalties--Oil and Gas Leases: Royalties: Generally

The lessee is required to place gas in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement. Where the value is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or another person, is providing certain services, the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition.

2. Indians: Mineral Resources: Oil and Gas: Royalties--Oil and Gas Leases: Royalties: Generally

"Marketable condition" means the "lease products are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.101 (1994). The concept of "marketable condition" entails not only the physical conditioning of the gas, but marketing services as well. For royalty purposes, a lessee is responsible for arranging transportation downstream of the delivery point, dealing with local distribution companies, aggregating nominations of customers on the same pipeline, finding purchasers, negotiating sales contracts and monitoring sales, the costs of storage, stock loss, inventory, receivables and equipment, and these are not deductible costs for purposes of royalty valuation. Also included are the costs of tax reimbursements, measuring, field gathering, compressing the gas, sweetening and dehydration, and royalty and production reporting.

3. Indians: Mineral Resources: Oil and Gas: Royalties--Oil and Gas Leases: Royalties: Generally

A Federal oil and gas lessee is under an obligation to market its production and must bear the expenses incurred in discharging that obligation. Where gas is purchased for treatment and resale, deductions from the value of the gas for these expenses are not allowed, whether incurred by the lessee or by another party, and it is immaterial that the services may have been performed after the gas has left the leasehold boundaries.

APPEARANCES: John G. Heinen, Oklahoma City, Oklahoma, for Appellant; Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE PRICE

AnSon Company (AnSon) has appealed from a joint Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), and the Deputy Commissioner of the Bureau of Indian Affairs (Joint Decision), dated September 25, 1995, denying AnSon's appeal of an October 13, 1994, order of the Dallas Compliance Division (DCD), MMS, to recalculate royalties. As a result of an MMS audit of AnSon's Federal and Indian leases, the DCD had ordered AnSon to recalculate royalties for each month from May 1, 1988, through December 1, 1993, and to determine additional royalties due on unprocessed gas production.

As a result of the audit, DCD determined that royalties were underpaid due to AnSon's payment of royalties on less than the gross proceeds accruing to the lessee for gas sold pursuant to the Gas Purchase Contract (Direct Sales) agreement (contract) with AnSon Gas Marketing (AGM), and specifically due to AnSon's payment of royalties on a sales price to AGM that reflected a 2-percent reduction for AGM's marketing charge. Article IV of the contract established the price as follows:

> 4.1 For all gas delivered by Seller and sold to Buyer, Buyer shall pay Seller a price per MMBtu, inclusive of all taxes and adjustments equal to ninety-eight percent (98%) of the average net proceeds received by Buyer. Average net proceeds shall mean all revenue received from applicable gas less any applicable third party transportation charges incurred prior to the point of resale.

Article V provided that the gas purchased would be delivered at the lease, that title passed at the point of delivery, and that AGM was deemed to be in exclusive control and possession of the gas after delivery. Article VI contained AnSon's warranty that the gas sold was merchantable pipeline quality and would "conform to the quality specifications of the receiving pipeline," with the understanding that AnSon would not be responsible for any additional costs to "cause such gas to so conform." It should be noted, however, that the gas here at issue was unprocessed gas sold at the wellhead.

Gas purchase statements from AGM show that the 2-percent deduction from the sales price was called an "AGM Sales Charge," which was consistent with the price established by the percentage of AGM's average net proceeds from subsequent sales that AnSon was to be paid pursuant to Article IV of the sales contract. The DCD concluded that this deduction was contrary to 30 C.F.R. § 206.152 (1993), which (1) provided that the value of production for royalty purposes shall not be less than the gross proceeds accruing to the lessee, less any applicable allowances, and (2) required the lessee to place the gas in marketable condition at no cost to the Federal Government or Indian lessor, unless otherwise provided in the lease agreement. Based on the DCD's review and AnSon's admission that it was its customary procedure to calculate and pay royalties based on the price AGM received, less the 2-percent reduction for AGM's marketing charge, DCD concluded that there was a systemic deficiency in AnSon's royalty calculation and payment procedures. (DCD letter to AnSon dated Oct. 13, 1994, at 2.) Therefore, DCD directed AnSon to recalculate royalties for each month from May 1, 1988, through October 1993, to bring royalty payments into compliance with all regulations.

AnSon appealed that order to MMS (MMS Appeal) by letter dated November 11, 1994. In its MMS Appeal, AnSon described the services provided by AGM as follows:

> AGM performs all the functions of a first purchaser, including payment of State Production/Severance Taxes, all first purchaser government reporting, negotiating gathering agreements with operators of gathering systems to get the gas from wellhead to AGM's purchaser and any and all other requirements of a first purchaser. AGM carries pipeline inventory balances while keeping the producer whole at the wellhead meter. For all of the above, AGM is justly compensated by a 2% gross profit margin.

(MMS Appeal at 1.) In that regard, Appellant asserted that AGM's market is typically "well beyond the lease boundaries from which the gas was purchased," and concluded that "[t]he cost of obtaining a market outside of the lease boundaries is not the responsibility of the lessee," which, according to Appellant, ends at the lease boundaries. (MMS Appeal at 2.) Appellant provided a proprietary schedule showing that the prices AGM paid from month to month tended to be higher than those of other purchasers of gas production from the Sadie 1-13 well.

As a result of the MMS Appeal, a Field Report dated March 28, 1998, was prepared. AnSon submitted its April 25, 1995, response to the Field Report (Response) to MMS. At the heart of the Response is AnSon's renewed assertion that it had "achieved its requirement to place the gas in marketable condition at the point in time that the sales contract for the highest possible price was entered into with its purchaser." (Response at 1-2.) Thus, AnSon characterized the services performed by AGM as first purchaser responsibilities, based in part on the fact that AGM paid a higher price than others purchasing from the same field, and in part on the fact that AGM's services were performed after sale at the wellhead, beyond the leasehold boundaries. (Response at 2-3.)

Noting AnSon's acknowledged practice with respect to its royalty calculations and the contention that the services performed by AGM were not necessary in order to place the gas in marketable condition, the Joint Decision concluded that AnSon's arguments reflected a misunderstanding of the concept of marketable condition. The Joint Decision determined that all of the services mentioned by AnSon constituted nondeductible expenses necessary to market production and concluded that AnSon was not relieved of its obligation to perform necessary marketing services by the transfer of lease production to another party. The DCD order to recalculate royalty was thus upheld.

In its statement of reasons for appeal to this Board (SOR), Appellant reiterates the arguments advanced before MMS. It is asserted that "[h]ad AnSon Company negotiated with a third party purchaser, completely outside of its affiliated entity to sell its natural gas, the MMS would not have taken exception to the price paid by that outside purchaser." (SOR at 1.) Noting that AGM paid a higher price than any other purchaser in the area for the period and well audited, AnSon claims that "AGM is not making any deductions from the price it pays for the product any more than any other third party purchaser would." (SOR at 2.) AnSon suggests that the 2-percent deduction taken by AGM is otherwise acceptable to MMS, provided the purchaser is not related to the lessee. (SOR at 2.) We make two brief points to rebut these arguments. First, as an affiliated entity, AGM is not a third party purchaser, and thus there is no basis for treating it as such. Second, the value of production for purposes of computing royalty must be at least equal to the actual proceeds, less applicable allowances, accruing to the lessee upon sale. 30 C.F.R. § 206.152(h); see also Walter Oil and Gas Corp., 111 IBLA 260, 262, 265 (1989); Supron Energy Corp., 46 IBLA 181, 188 (1980), appeal dismissed sub nom. Supron Energy Corp. v. Hodel, Civ. No. 80-0463 JB (D.N.M. 1980), Conoco, Inc. v. Hodel, Civ. No. 80-261C (D.N.M. 1980), Exxon Corp. v. Hodel, Civ. No. 80-430 JB (D.N.M. 1980), due to Jicarilla Apache Tribe v. Supron Energy Corp., 728 F.2d 1555 (10th Cir. 1984), rehearing 782 F.2d 855 (1986), modified 793 F.2d 1171 (1986), cert. denied 479 U.S. 970 (1986); Amoco Production Co., 29 IBLA 234, 236 (1977).

The MMS filed its reply, styled a Motion to Dismiss or in the Alternative - Answer. 1/ In its Answer, MMS argues that it is well established that a lessee cannot escape its duty to market production and that the duty exists regardless of whether the costs of marketing the gas are paid directly by the lessee or by a third party. Thus, it contends that the sale price, plus the deduction for AnSon's marketing costs, was the proper valuation of gas production for royalty purposes.

[1] The Director's Decision must be affirmed. The governing regulation, 30 C.F.R. § 152(i) (1994), 2/ clearly defines the lessee's responsibility as follows:

> The lessee is required to place gas in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement. Where the value established pursuant to this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition.

California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961); Amoco Production Co., 112 IBLA 77, 87 (1989); The Tax Co., 64 I.D. 76, 79 (1957).

[2] "Marketable condition" means the "lease products are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.101 (1994). The concept of "marketable condition" entails not only the physical conditioning of the gas, but marketing services as well. Thus, for royalty purposes a lessee is responsible for arranging transportation downstream of the delivery point, dealing with local distribution companies, and aggregating nominations of customers on the same pipeline. ARCO Oil & Gas Co., 112 IBLA 8, 10 (1989). Finding purchasers, negotiating sales contracts, and monitoring sales are also the lessee's responsibility. Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), aff'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984). Marketing costs includes the costs of

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1/ In support of the Motion to Dismiss, MMS alleged that AnSon had failed to file a statement of reasons within the meaning of 43 C.F.R. §§ 4.412(c) and 4.402, in that Appellant's submissions failed to affirmatively explain why the Decision is erroneous. We disagree, and accordingly, the Motion to Dismiss is denied.

2/ The regulation at 30 C.F.R. § 152(i) was amended in 1996 to delete the reference to Indian leases, and was republished as 30 C.F.R. § 206.52(i). The valuation regulations remained unchanged, except that the reference to the Federal Government in § 206.52(i) was deleted. 61 Fed. Reg. 5448 (Feb. 12, 1996).

storage, stock loss, inventory, receivables, and equipment. Amoco Production Co., 112 IBLA 77, 87 (1989). As we said in R.E. Yarbrough & Co., 122 IBLA 217, 221 (1993), the costs of placing the gas in marketable condition include tax reimbursements, measuring, field gathering, compressing the gas, sweetening, and dehydration. And contrary to AnSon's argument, the duty to place the gas in marketable condition also includes royalty and production reporting. ARCO Oil & Gas Co., supra.

In R.E. Yarbrough, supra, we considered a sales arrangement similar to the one here presented. In that case, Yarbrough sold its gas production to Natural Gas Operations Company (NGO), which maintained a low pressure gas gathering system. NGO gathered the gas and dehydrated and compressed it, which was necessary to permit the gas to be marketed in a standard high pressure gas pipeline, and thereafter sold it to a third party. Like Appellant's price, the price NGO paid Yarbrough was the price paid by a third party purchaser, less NGO's gathering, compression and dehydration costs. Yarbrough argued that the gas was in marketable condition when sold to NGO, since Yarbrough was unable to sell its gas directly to a standard high pressure pipeline because there was no connection available. Like Appellant here, Yarbrough's price was determined by a further sale after NGO conditioned the gas for market, leading us to conclude that the gas had not been placed in marketable condition until NGO did so on Yarbrough's behalf. The same conclusion must be reached here, as Appellant does not dispute that the production here involved was unprocessed gas sold at the wellhead.

[3] The Joint Decision is correct in its finding that by accepting a reduction in the sales price AnSon in effect paid AGM to perform certain functions that were incidents of marketing the gas, and thus they cannot be deducted from gross proceeds for purposes of royalty valuation. For royalty purposes, there is no distinction between the lessee's acceptance of a price that reflects a reduction for the performance of marketing functions and paying a contractor outright to undertake these functions. ARCO Oil & Gas, supra, at 10; Walter Oil and Gas Corp., supra, at 265; Placid Oil Co., 70 I.D. 438, 439-40 (1963). In such circumstances, it is immaterial that the services may have been performed after the gas has left the leasehold boundaries. Thus, MMS was correct in its determination that royalties were paid on less than the gross proceeds and must be recalculated.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Joint Decision appealed from is affirmed.

T. Britt Price
Administrative Judge

I concur:

David L. Hughes
Administrative Judge